

CFTC Proposes to Adopt NFA's Request to Delete CPO Exemption Used by Mutual Funds and to Eliminate Other Widely Used CPO Exemptions

February 9, 2011

In a sign of its increased regulatory muscle, on January 26 the Commodity Futures Trading Commission (CFTC) issued proposed rules regarding commodity pool operators (CPOs) that not only proposed eliminating the CFTC Rule 4.5 exemption, as petitioned by the National Futures Association (NFA), but also proposed removing the exemptions from CPO registration contained in Rules 4.13(a)(3) and 4.13(a)(4), which are relied on by a substantial portion of the hedge fund industry. If adopted, these changes will require full CPO registration by registered and private fund advisers, sponsors, or other operators of funds that invest even a minimal amount of assets in listed futures or other listed commodity positions, such as commodity options or swaps.¹ The proposed rules do not include any transition period or grandfathering provisions. As a result, if the rules are adopted as proposed, operators of funds that hold listed futures positions as of the effective date will need to be fully registered as CPOs. The proposal will be open for comment for 60 days after publication in the *Federal Register*.²

Private Funds CPO Exemptions

CFTC Rule 4.13(a)(3) currently provides an exemption from CPO registration for persons that meet the following criteria: (i) they operate pools exempt from registration under the Securities Act of 1933 (Private Funds); (ii) they offer those pools only to sophisticated investors referred to in CFTC Rule 4.7 as qualified eligible persons (QEPs), accredited investors, or knowledgeable employees; and (iii) the aggregate initial margin and/or premium attributable to commodity interests in each pool does not exceed 5% of the liquidation value of a pool's portfolio. Rule 4.13(a)(4) provides an exemption from CPO registration for persons that operate Private Funds offered only to institutional QEPs and natural persons who meet both definitional and portfolio QEP requirements, regardless of the amount of commodity interests held by the pool. The proposed rules completely rescind both Rule 4.13(a)(3) and 4.13(a)(4).

If the CFTC adopts the proposed rules, those persons operating Private Funds (i.e., advisers or other persons associated with the fund) that invest in commodity interests, including swaps (after July 21, 2011), will have to register as CPOs with the CFTC and become NFA members. Even if a fund is

1. Section 721(4) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which becomes effective on July 21, 2011, amended the definition of a "Commodity" under the Commodity Exchange Act to include swaps. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

2. The proposed rules may be found on the CFTC website at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister012611b.pdf>.

investing in a limited amount of commodity interests, the operator will generally be required to register as a CPO and be subject to CFTC and NFA rules and regulations.³

Full registration as a CPO is a relatively involved process and typically takes from six to eight weeks to complete. Registration involves submission of Form 7-R for the CPO and Form 8-Rs for all natural person Principals and all Associated Persons (APs) along with fingerprints for each such Principal and AP, as well as proof that each such Principal and AP passed the required proficiency exam (generally the Series 3 or 31). At least one Principal will be required to be registered as an AP. Unlike operators currently operating under the exemption, fully registered CPOs will also be subject to CFTC and NFA regulation. Such regulation includes providing disclosure documents to pool participants that are subject to review by NFA and fulfilling certain recordkeeping and periodic and annual reporting requirements, including delivery of audited annual financial statements.

Registered CPOs also rely on CFTC Rule 4.7 for relief from certain requirements. Rule 4.7 currently provides relief from the disclosure, recordkeeping, and reporting requirements for CPOs that offer interests in private pools investing in commodities solely to QEPs. Currently, Rule 4.7 provides that a CPO claiming relief under the rule is not required to provide its pool participants with audited annual financial statements. The CFTC's proposal would rescind this relief and require CPOs operating pools pursuant to relief under Rule 4.7 to have the annual financial statements for each pool certified by a public accountant.⁴ The proposal would not, however, rescind the other types of relief offered under Rule 4.7.

The rescinding of Rule 4.13(a)(3) and 4.13(a)(4) would also mean that a number of investment advisers will be required to register with the CFTC as a commodity trading advisor (CTA). Investment advisers that currently operate under an exemption from CTA registration based on the fact that they provide advice only to pools that are exempt under Rules 4.13(a)(3) and 4.13(a)(4) will, if the proposal is adopted, be required to register as CTAs with the CFTC and become NFA members.⁵ These advisers will also be subject to the full scope of CFTC and NFA requirements applicable to CTAs.

Mutual Funds CPO Exemption

CFTC Rule 4.5 currently provides an exclusion from the definition of CPO for persons operating otherwise regulated entities, such as sponsors and advisers of registered investment companies. Prior to August 2003, persons claiming eligibility for the exclusion under Rule 4.5 were required to represent that commodity futures or options contracts entered into by the qualified entity were for *bona fide* hedging purposes⁶ and that the aggregate initial margin and/or premiums for positions that did not meet the *bona fide* hedging criteria did not exceed 5% of the liquidating value of the qualifying entity's portfolio, after taking into account unrealized profits and losses. The rule further required that participation in the qualifying entity not be marketed as participation in a commodity pool or otherwise as a vehicle for trading commodity futures or options. In August 2003, as part of a larger overhaul of its regulation of CPOs and CTAs, the CFTC eliminated as conditions to eligibility for Rule 4.5 that the qualified entity

3. Prior to the adoption of Rule 4.13(a)(3), the CFTC consistently provided that there is no exception to having to register as a CPO based on a pool making *de minimis* investments in commodity interests. See CFTC Interpretative Letter No. 98-79, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,502 (Nov. 20, 1998); CFTC Interpretative Letter No. 98-18, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,276 (Mar. 12, 1998).

4. The proposed rules also amend Rule 4.7 to incorporate the new accredited investor standards by reference to the applicable SEC rule rather than including the terms of the rule, so as to avoid having to amend Rule 4.7 in the event that the SEC later changes the accredited investor standard.

5. See CFTC Rule 4.14(a)(8) (17 C.F.R. § 4.14(a)(8)).

6. *Bona fide* hedging transactions and positions are defined at CFTC Rule 1.3(z) (17 C.F.R. § 1.3(z)).

limit speculative trading to 5% of the liquidating value of its portfolio and not market itself as a vehicle for exposure to commodity futures or options.⁷

In a petition for rulemaking submitted last year, NFA requested that the CFTC reinstate the requirement that persons claiming exclusion from the CPO definition represent that the qualifying entity will not be marketed as a vehicle for trading in or providing exposure to commodity futures or options and that the aggregate initial margin and premiums for establishing speculative commodity futures and options positions not exceed 5% of the liquidation value of the qualifying entity's portfolio, after taking into account unrealized profits and losses.⁸ On September 17, 2010, the CFTC requested comments on NFA's petition for rulemaking.⁹ Although comment letters filed with the CFTC noted that many of the CFTC regulations for CPOs and commodity pools that would come into effect as a result of the proposal would conflict with securities regulations to which investment companies are also subject,¹⁰ the CFTC did not address these concerns in the proposal.

The proposed rules would adopt NFA's suggested language and approach. As a result, an operator of a registered investment company will no longer be able to rely on Rule 4.5 to avoid registration as a CPO if the investment company invests more than an immaterial amount of its assets for speculative purposes in commodities. In order to rely upon Rule 4.5, as it is proposed to be amended, the investment company will have to limit the initial margin it posts for its speculative commodities-related trading (including, after July 21, 2011, swaps), to 5% of the liquidating value of its portfolio, and ensure that marketing materials do not describe participation in the investment company as a means to obtain exposure to commodity futures or options.

The proposed amendments to Rule 4.5 are limited to registered investment companies and would not affect the existing exclusion for other entities, such as insurance companies, banks, or trustees of certain pension plans. If adopted, the proposal will effectively require registered investment companies to register the operator of any fund investing, to any material extent, in futures, options, or swaps other than for *bona fide* hedging purposes.

In addition, as a result of the proposed changes, the exemption from CPO registration provided by Rule 4.13 would apply to only a limited number of fund operators. The exemption would continue to be available for operators that (i) operate only one pool, do not solicit participants for that pool, do not receive compensation for operating the pool, and are not affiliated with any person required to register

7. 68 Fed. Reg. 47221 (Aug. 8, 2003).

8. See the Morgan Lewis LawFlash regarding NFA's revised Petition, "NFA Revises Petition to Restrict Exclusions from Commodity Pool Operator Definition" (Aug. 19, 2010), available at http://www.morganlewis.com/pubs/IM_NFACommodityPoolOpDef_LF_19aug10.pdf; see also the Morgan Lewis LawFlash regarding the CFTC's Request for Comment on NFA Petition, "CFTC Requests Comment on NFA Petition to Restrict Exclusions from Commodity Pool Operator Definition" (Sept. 20, 2010), available at http://www.morganlewis.com/pubs/IM_Exclusions-CommodityPoolOperatorDef_LF_20sept10.pdf.

9. See the Morgan Lewis LawFlash regarding CFTC's request for Comments, "CFTC Requests Comment on NFA Petition to Restrict Exclusions from Commodity Pool Operator Definition" (Sept. 20, 2010), available at http://www.morganlewis.com/pubs/IM_Exclusions-CommodityPoolOperatorDef_LF_20sept10.pdf.

10. See, e.g., Comment letter from Morgan Lewis partner W. John McGuire, *Re: National Futures Association Petition to Amend Commission Rule 4.5* (Oct. 18, 2010), available at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26314&SearchText>.

with the CFTC;¹¹ or (ii) operate pools each of which has 15 or fewer participants and combined total gross capital contributions not exceeding \$400,000.¹²

Updating Claims for Exemption

Currently, Rules 4.5, 4.13, and 4.14 require that persons claiming relief from registration with the CFTC must electronically file a notice claiming such exemption at inception. The proposed rules would require that within 30 days of the anniversary of the initial notice filing, in order to retain eligibility for the exemption, persons who are still eligible for relief under Rules 4.5, 4.13, and 4.14 must affirm the accuracy of their original notice of exemption, amend the notice in order to retain exemptive status, or withdraw the exemption and apply for registration.

The proposal also included new disclosure requirements for CPOs and CTAs. These are discussed in our February 4, 2011 LawFlash.¹³

Implications

The proposal is subject to a 60-day comment period upon publication in the *Federal Register*. If the CFTC determines to adopt the proposal, it will have to publish final rules in the *Federal Register* setting forth an effective date by which those persons that have claimed relief under Rules 4.5, 4.13(a)(3) and 4.13(a)(4) will have to either revise or cease their commodity interest trading or register as CPOs with the CFTC and become NFA members.

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

New York

Georgia Bullitt	212.309.6683	gbullitt@morganlewis.com
Michael A. Piracci	212.309.6385	mpiracci@morganlewis.com
F. Mindy Lo	212.309.6693	mindy.lo@morganlewis.com

Miami

Ethan W. Johnson	305.415.3394	ejohnson@morganlewis.com
Rebecca Leon	305.415.3396	rleon@morganlewis.com

Washington, D.C.

W. John McGuire	202.739.5654	wjmcguire@morganlewis.com
Barry I. Pershkov	202.739.5675	bpershkov@morganlewis.com
Laura E. Flores	202.739.5684	lflores@morganlewis.com

About Morgan, Lewis & Bockius LLP

With 23 offices in the United States, Europe, and Asia, Morgan Lewis provides comprehensive transactional, litigation, labor and employment, regulatory, and intellectual property legal services to

11. CFTC Rule 4.13(a)(1) (17 C.F.R. § 4.13(a)(1)).

12. CFTC Rule 4.13(a)(2) (17 C.F.R. § 4.13(a)(2)).

13. See the Morgan Lewis LawFlash, "SEC and CFTC Propose Reporting Requirements for Investment Advisers to Private Funds" (Feb. 4, 2011), available at http://www.morganlewis.com/pubs/IM_LF_ReportingRequirementsForInvestmentAdvisers_04feb11.pdf.

clients of all sizes—from global Fortune 100 companies to just-conceived startups—across all major industries. Our international team of attorneys, patent agents, employee benefits advisors, regulatory scientists, and other specialists—nearly 3,000 professionals total—serves clients from locations in Beijing, Boston, Brussels, Chicago, Dallas, Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, Minneapolis, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, Washington, D.C., and Wilmington. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.

This LawFlash is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered **Attorney Advertising** in some states.
Please note that the prior results discussed in the material do not guarantee similar outcomes.

© 2011 Morgan, Lewis & Bockius LLP. All Rights Reserved.

